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SENSITIVE

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TAGS: ECON ENRG EFIN EINV BR
SUBJECT: OUTLOOK FOR BRAZILIAN NATURAL GAS MARKET POSITIVE

REF: 08 Sao Paulo 31

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Brazil's Congress has passed natural gas legislation that would create specific roles for production, distribution, and commercialization of natural gas. The original bill, passed by Brazil's lower house in August 2007 and then with revisions in the Senate on December 3, clarifies private access to Petrobras natural gas pipelines, which should improve the investment climate and overall competitiveness of the sector. The bill is the result of intense cooperation across the public and private sector and expectations are that the bill will be signed into law by the President this year. This bill comes at a time of falling demand for natural gas, (due to a decline in industrial production courtesy of the financial crisis and heavy rainfall feeding hydro-electric reservoirs reducing the need for gas-fired power plants), as well the need to reform the pricing structure of natural gas which adjusts much more slowly than oil resulting in market imbalances. As a result of this fall in demand, the GOB contemplated a significant reduction in natural gas imports from Bolivia, but retracted its decision after further consideration of its contract terms. With the current excess supply, as well as potential natural gas production from the pre-salt discoveries, Petrobras is analyzing the creation of an export platform to transform Brazil into a regional natural gas exporter. End Summary.

Natural Gas Legislation Based on Industry Consensus
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¶2. (U) The Government of Brazil (GOB) introduced ordinary legislation to differentiate natural gas from petroleum in 2007 and was approved by the Chamber of Deputies (lower house) in August
¶2007. Debates and revisions ensued until the Senate approved its version of the bill on December 3, 2008. The bill fills a legal gap on regulation of natural gas, which was previously addressed as a chapter in the Petroleum Law. The legislation defines the upstream, midstream, and downstream functions, as well as pipeline usage, construction of LNG terminals, and distribution pipelines. Improving the business climate, the bill creates stable rules of access for private investors to Petrobras' pipelines that would facilitate investments in gas production and transport. New gas

pipelines would also be developed via concessions, which would provide additional guarantees and increase competition for the private sector. Currently, Petrobras holds a near monopoly over the country's existing pipelines and negotiates terms on a case-by-case basis, so private investors are hesitant to produce natural gas to supply the domestic market.

¶3. (SBU) One new area of coverage is the inclusion of state-level regulators in the process. Carlos Montagna, Director of Natural Gas Supply for Comgas, Brazil's largest gas distributor, told Econoff that the lack of clear federal natural gas laws has allowed state regulators freedom to interpret the application of federal law. The new legislation defines various consumers, but delegates to Brazilian state authorities the ability to segment the market into free consumers that could purchase natural gas directly from private sector importers or producers, and regulated consumers that must buy from a state distributor. According to Montagna, natural gas intensive industrial consumers want to become "free" to buy directly from the source to avoid the fees and state taxes associated with state distribution agents. Montagna expects that the Sao Paulo market will officially open in 2011, removing the monopoly for distribution and commercialization currently held by state government distributors. Montagna told Econoff that Rio de Janeiro had already instituted this "free market" program this year.

¶4. (SBU) Montagna participated in the discussions leading to the December vote, where he said the Senate brought together many associations and agencies, including Petrobras and the Brazilian Association of Natural Gas Distributors (Abegas), to come to a balanced result. Perhaps more delicate, Montagna opined, would be the process of reconciling differences between federal and state

laws because it is a federal law but involves state-level distribution. Though Montagna believed the legislation is technically unconstitutional because Brazil's constitution grants the central government a monopoly over gas transportation (via Petrobras), he stated that the legislation as written is preferred to none at all.

Pricing Imbalance Remains Problem

¶5. (SBU) The new legislation will go a long way in improving the investment climate for natural gas, but does not correct the inefficient pricing structure for natural gas. Unlike gasoline, diesel, and butane, the retail price for natural gas is adjusted quarterly. Montagna explained that this quarterly lag is closer to a six month lag on international prices because Comgas' wholesale cost for Bolivian gas is readjusted every three months based on a basket of petroleum product prices over the previous six months. The system creates a sizeable deficit when international oil prices have rapid swings and the distributor cannot adjust. In December, Comgas was paying USD 9 per million BTU and selling for USD 7.20 per million BTU, which created a deficit of USD 225 million over that quarter. Data from Abegas shows that natural gas prices climbed 40 percent from September 2007 to 2008, but not enough to cover the difference between what Comgas pays and then must charge for natural gas. As a result, the state of Sao Paulo energy and sewage regulator (ARSESP) approved an extraordinary price readjustment for Comgas and another Sao Paulo distributor in December 2008 for industrial, commercial, and vehicular natural gas consumers.

¶6. (SBU) The current structure also means that despite the decline in oil prices, natural gas prices in Brazil do not yet reflect the decline in oil prices. Montagna complained that natural gas prices in Brazil are currently uncompetitive, especially with fuel oil, which has a much lower price at the moment because it readjusts weekly based on oil prices. Montagna indicated that some of Comgas' more flexible industrial customers had started taking advantage of lower fuel oil prices. Montagna expected the substitution to be temporary, at least in the state of Sao Paulo (the largest industrial natural gas consumer), because the state environmental agency is very proactive and industrial customers do not have the permits for higher emissions that result from burning fuel oil instead of natural gas.

Financial Crisis and Rainfall Slow Demand

¶7. (SBU) Demand for natural gas is down by approximately 20 percent, primarily due to a comparable decline in industrial production. (Note: Industrial production fell by 19.8 percent in the last quarter of 2008 compared to the same period in 2007. End Note.) According to Abegas, Brazil's industrial sector comprised 52 percent of natural gas consumption in 2008. Montagna clarified that December, January, and February are seasonally lower natural gas consumption months, but that the collective furloughs, particularly for the pulp and paper and auto industries, have had a profound effect on natural gas consumption.

¶8. (U) In addition to industrial consumers that power directly from natural gas, Abegas calculated that gas-fired power plants comprised 27 percent of natural gas demand in 2008. Gas-fired power plants are turned on during drought periods and to reduce demand for hydropower to allow reservoirs to refill. While the 2008 demand increased by 150 percent over 2007 because of low reservoir levels for hydroelectric generation, the GOB powered down more than 10 gas-fired power plants due to ample rainfall so far in 2009. As of the last week of February, reservoir levels nationwide were at 73 percent of capacity.

Rethinking Bolivia

¶9. (SBU) Facing a sudden abundance of natural gas at the close of

2008, the GOB announced that Petrobras should cut imports from Bolivia by more than a third, sparking Bolivian President Evo Morales to immediately send representatives to Brasilia. Within a week, the GOB backtracked on its decision and returned imports to approximately 24 million cubic meters per day (MMm3/d). According to press statements, the reduction to 19MMm3/d would have cost the Bolivian government USD 600 million in lost revenue from January to April. Despite political pressure, Montagna pointed to the take-or-pay contract as the underlying rationale for not reducing to their originally announced 19mm3/d. Under its contract with Bolivia, Brazil must buy on average 24.8MMm3/d over the year, and a monthly average of no less than 19MMm3/d. Montagna stated decreasing now would only result in an increase later in the year to avoid paying for natural gas Brazil did not import, and the decision to keep an extra four gas-fired power plants online would put approximately 1,000 megawatts into the system.

¶10. (SBU) Bolivia has limited pipeline capacity to Argentina, its only other export market, preventing a dramatic increase in natural gas exports there. For its part, Argentina pays more for Bolivian natural gas, but Bolivia had not been meeting its contract terms with Argentina for some time. The La Paz Econoff noted that even if Argentina wanted Bolivia to fulfill its contract, the lack of progress on expanding the pipeline south remained a bottleneck. Without an alternative market, the fiscal impacts of a reduction in Brazilian imports on Bolivia's economy would have been devastating. Bolivia's tax structure is based on production volumes, and while Bolivian states would be anticipating tax revenues at the contracted production rate, they would instead receive revenues on actual production. Another bottleneck in Bolivia, limited storage capacity, would mean a decline in production without any place to store excess production.

Future Demand Growth Likely

¶11. (SBU) Montagna underscored that domestic production and demand outlook remained positive despite the recent slump. He pointed to the timeline for the LNG terminals as an example and stated that the LNG terminal in the state of Rio de Janeiro should be completed in the first half of this year. Similarly, Montagna told Econoff that natural gas development for production at Mexilhao is on track, and Tupi and other pre-salt developments are making progress. The environmental licensing that had delayed Mexilhao was resolved, with

production for this year expected to be about 3 to 4MMm3/d and up to 8MMm3/d in 2010. He also pointed to the recently formed group that Sao Paulo State has put together, including state level agents that should speed up the process of bringing new natural gas discoveries on line. The group was formed in Novembe 2008 and will start working in March.

¶12. (SBU) Comgas has a relatively good picture for future demand growth based on requests for incoming supply contracts. Montagna outlined Comgas' revised projections for industrial demand, increasing from the 1.5MMm3/d to 6MMm3/d by 2012, a more than fourfold increase over current consumption. Despite the economic crisis, Montagna expects Comgas' demand to be stable this year due to its emphasis on building residential access. Comgas last year began using a new technology that allows distribution pipelines to be installed below sidewalks (versus streets), at two-thirds of the cost. Comgas also offers credit lines for low income residents to replace electric showers with gas heaters, which Montagna hopes will also expand their residential customer base.

Gearing Up for Exports?

¶13. (SBU) Petrobras announced on February 10 its intention to invest in infrastructure to become a natural gas exporter. According to the press statement, Petrobras' strategy would be to liquefy and then stockpile excess natural gas capacity to then export to the Southern Cone, United States, and Europe. According to Petrobras' Director of Gas and Energy, Graca Foster, the company

plans to extend its contract with Bolivia which currently expires in 2019, indicating that Brazil could become an export platform for Bolivian natural gas. These plans include two liquefied natural gas terminals and an additional liquefaction plant with an initial capacity of 10MMm3/d to be built near the merger of gas pipelines from Minas Gerais, Rio de Janeiro, and Sao Paulo states. Indeed, Petrobras engineers told Rio Econoff that the company plans to use offshore floating LNG facilities for Tupi and other pre-salt fields. Petrobras' plans to export could provide an additional incentive to begin developing these facilities.

Comment

¶14. (SBU) The chances that President Lula will sign the new natural gas legislation are high given the GOB's interest in pursuing reform of the sector. While the legislation does not treat the issue of improving the pricing system for natural gas, this legislation will still strengthen the investment climate for natural gas as it regularizes access to pipelines and allows the private sector greater freedom in setting supply contracts. This legislation should lead to increases in domestic production that will augment an already over-supply of natural gas from Bolivia due to lower industrial demand and an abundance of rainfall. These factors will position Brazil to begin thinking about its role as a potential regional exporter for the additional domestic production that will come online from the pre-salt discoveries as well as re-exporting imports from Bolivia. End Comment.

¶15. (U) This cable was coordinated/cleared by Embassies Brasilia and La Paz and with Consulate Rio de Janeiro.

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